

BRIEFING MEMO

TO: Greg Malcolm
COMPANY: Apple Computer
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I. Introduction

In our discussions with Apple over the last several months, we have been trying to assist the company in its restructuring efforts and have discussed a number of opportunities with the company. Given that Apple is aggressively trying to rationalize its expense base, most of our discussions have focused on potential divestiture and spin-off candidates.

II. Background

Initially, we had been working with Apple's treasurer, Jane Risser, after meeting her in August 1996. This introduction was made through Societe Generale's commercial banking relationship with Apple handled by the San Francisco office. However, it became apparent from our discussions that we needed to interface with the corporate development group. In late 1995, I met Gary Madden, a manager in the group, at the Red Herring conference in San Francisco, and Gary and I have kept in touch since that initial meeting. After failing to meet on a trip in late 1996, Gary and I decided to meet in early February. Gary thought that the timing was very appropriate given the internal discussions that Apple was having in its most recent restructuring. We have pursued this relationship given the internal activity, and we believe that there may be discreet opportunities to advise Apple on certain elements of this restructuring. Since February 1997, our discussions have been with Doug Solomon, the head of corporate development, and his team including Dudley Andersen - senior director, Joe Stockwell - director and Gary Madden - manager.

II. Current Opportunity for SGSC

We have been actively discussing the potential of a leveraged disposition of Apple's imaging business which includes the sales of printers, monitors, scanners, and digital cameras. The imaging business generates sales of approximately \$1.2 billion. Given that Apple hopes to focus its attention on its core business, the imaging business should be considered as a divestiture candidate. Also, the strong performance of the clones indicates that Apple printers may be better handled by an independent company. We have the opportunity to advise Apple on this transaction in which we could lead the placement of the senior and subordinated debt along with the equity component. Our initial analysis indicates that this leveraged divestiture could generate \$1 billion in pre-tax cash to Apple.

III. Initial Ideas

While concerns about the long-term viability of Apple will be solved internally (via the acquisition of NeXT Computer and other developments), Apple faces continued pressure to refocus its operations. During our initial meeting with Doug Solomon's team, we presented five specific divestiture and spin-off ideas to Apple:

- Going private (\$1.3 billion total firm value at the time, \$1.8 billion currently).
- Divestiture of Apple's interest in ARM, a semiconductor design company located in the UK. We introduced Intel to the company and await their decision. The market value is estimated to be \$400-500 million with Apple holding 42% of the company.
- Leveraged divestiture of the imaging division. Currently generates approximately 15% of Apple's revenues and has been a strong cash flow generator.
- Partial or complete spin-off of the Newton business. They are currently in discussions with a consumer electronics company with an enterprise value of approximately \$70 million, and they have asked us to consider a possible equity investment. While they feel that the Newton's prospects are very strong, Apple realizes that they need to focus their operations.
- Partial or complete spin-off of Claris, the software applications business. Not likely given that Claris handles distribution for all MacSoft products (Quicktime layer, etc.), so MacSoft would lose its distribution.

IV. Leveraged Divestiture of Imaging Business

The imaging business generates sales of approximately \$1.2 billion and includes the sales of printers, monitors, scanners, and digital cameras. Most of the manufacturing and distribution is handled by Apple.

- A. Background: The traditional justification for keeping the business at Apple has been that it is a high connect-rate business and is driven largely by sales of Apple CPUs. We pitched the divestiture idea based on the success of the MacOS licensees. Typically, people buy Apple imaging products as an addition to Apple computers (i.e. sales of printers are connected to sales of CPUs - therefore, high connect-rate), but as licensees sell more Mac computers, the connect-rate with the Apple imaging division drops. In the latest industry report, an increasing portion of the Macintosh market is held by clones (Macs have 7.2% of the PC market, Apple has 5.4% and the clone makers have 1.8%). In effect, clone makers have 25% of the market, up from 0% two years ago. With more sales coming from clone makers, buyers concentrate on the MacOS logo instead of the Apple logo (thus, the connect-rate with Apple branded printers will decrease). Thus, as sales of clone makers have begun to rise (up to 25% market share by some estimates), we believe that the connect-rate rationale becomes a less relevant rationale for Apple to maintain this business.
- B. Key issues: The rationale for the spin-off is strong. Apple does not need to be in the printer business but this division generates sales of \$1.2 billion and is a strong cash flow generator for the company. In fact, this is probably the reason that they have kept it despite the fact that it is probably a corporate orphan that could do better as an independent company. However, we believe that a leveraged disposition of the imaging business would help Apple to lower operating expenses and would also allow Apple's general management to more closely focus on its remaining core businesses. As a corporate orphan, the business could probably be run more efficiently as an independent company (e.g. Lexmark - IBM's former printer business which was sold to Clayton Dublier).

- C. **New Business Model:** Independence creates a new opportunity for the imaging group. As sales of clones rise, it gives the imaging business an opportunity to create an independent business that is not totally dictated by Apple and can sell to the clone makers. Additionally, this new independent company may even extend the independence story by developing printers for the non-Macintosh market. Apple is very cognizant of market trends. For example, the Newton has better Windows capability than most Windows-based PDAs and many of their application software products are created for the Windows platform. Another example is that Quicktime has just been ported to the Windows market. For the imaging business to be independent, we need to examine the infrastructure that needs to be built - the imaging business currently leverages the Apple infrastructure very heavily (sales and marketing, manufacturing, etc). They need to build a sales channel and may build relationships with VARs and resellers in order to penetrate markets where Apple's distribution has not been particularly strong. They also might subcontract a greater portion of the manufacturing. For example, they already have some agreements in place with HP and Canon and could possibly extend them.
- D. **Financial analysis:** Our preliminary analysis indicates that this leveraged disposition could generate compounded annual internal rates of return in excess of 30% for the equity sponsors while realizing more than \$1 billion in pre-tax cash proceeds to Apple. Obviously, Apple would need to have certain supply agreements in place, and these agreements would also help the new company while it builds its independent sales and distribution network. It also might make sense for Apple to maintain a minority equity position in the new company in order to maintain some of the upside potential and allow for an orderly transfer to an independent entity (sales and marketing, manufacturing operations, etc). We further understand that the imaging division has already been organized separately which would help to facilitate such a transaction. We have received Apple's initial comments on our assumptions regarding the financial projections that support the leveraged divestiture analysis. They are as follows:
- Revenues: Apple estimates that sales are approximately \$1.2 billion for the imaging business which includes the sales of printers, monitors, scanners, and digital cameras. Apple estimates that sales will grow at 10% per year.
- Gross Profit: Apple's gross margins in its printer business range from the low twenties to forty percent. Apple has said that a simplifying assumption for gross margins would be approximately 30% with eventual growth to 32% over five years. This improvement assumes increased organizational efficiency realized from operating as an independent company with the proper incentive structure for management and the workforce. Additionally, Apple would no longer manufacture printers and could possibly extend some existing manufacturing agreements with HP and Canon which should also help to improve gross profit.
- SG&A: This expense is estimated at 16% of sales. Of course, we realize that the imaging division currently leverages the Apple infrastructure very heavily and that the division will need to reexamine and broaden its distribution channels. We believe that this eventually would allow the division to reduce its in-house SG&A expense.
- R&D, Capex and WC: These expenses have been estimated based on publicly available information from similar companies including Lexmark.
- Structure: The transaction structure was modeled based on preliminary discussions with Howard Park and Olivia Feldman and is similar to the Lexmark structure (60/40 debt/equity with a subordinated debt component of \$150-200 million). Additionally, these numbers allow the business to maintain adequate coverage in the early years while producing 30% returns to the equity sponsors.

Current Situation at Apple

- The company has undergone two restructurings and lost more than \$1 billion since Gil Amelio took over in February 1996. In the latest restructuring, the company laid off 4,100 workers (about 30% of the workforce) with an accompanying restructuring charge of \$155 million. The company also recorded a charge of \$375 million relating to its acquisition of NeXT. The workforce reductions are part of Apple's effort to cut \$500 million in operating expenses.
- Takeover rumors have been strong for the past two years. Larry Ellison is currently reviewing a possible bid, and Prince Al-Waleed Bin Talal of Saudi Arabia has purchased 5% of the equity. Also, Sun was rumored to be interested last year at a price of \$25-35 a share with IBM the rumored bidder the previous year at a price of \$40-50.
- Outlook: While most of the recent news has been somewhat negative, Apple still has a very loyal customer base, with very strong franchises in the publishing and education markets. The recent OS efforts have been to create a very developer friendly environment that would allow the development on a Mac with playback on all platforms (Mac, Sun, NT). If successful, this would draw developers back to the Mac without having to worry about the market share numbers of the Mac market. And once the developers start going back to the Mac platform, the applications available to the business and consumer markets should increase.
- Recent financial performance: Sales continued their declining trend as sales in for Q2-97 were \$1.6 billion compared to \$2.1 billion for Q1-97 and \$2,200m for Q2-96. The decline in sales is largely attributable to declining worldwide demand of most product categories especially the Performa line, which has since been discontinued. Apple attributed its decline to \$200m in channel inventory coupled with typical seasonal slowness. Approximately, 50% of Apple's sales are international. Excluding the charges for restructuring and the write-off of in-process R&D, income from operations remained negative at (\$310 million) while operating expenses from the latest quarter were down \$65m from the same period a year ago, primarily due to continued pricing actions, such as rebates, in most product lines in an attempt to stimulate demand.
- Historical Financials

| (S in millions) | | | | | Six Months Ending | |
|----------------------------|---------|---------|----------|-----------|-------------------|---------|
| | 9/93 | 9/94 | 9/95 | 9/96 | 3/29/96 | 3/28/97 |
| Net Sales | 7,977.0 | 9,189.0 | 11,062.0 | 9,833.0 | 5,333.0 | 3,730.0 |
| <i>Sales Growth %</i> | | 15.2% | 20.4% | (11.1%) | | (30.0%) |
| Cost of goods sold | 5,249.0 | 6,846.0 | 8,204.0 | 8,865.0 | 5,279.0 | 3,030.0 |
| <i>Gross Profit Margin</i> | 34.2% | 25.5% | 25.8% | 9.8% | 1.0% | 18.8% |
| SG&A | 1,632.0 | 1,384.0 | 1,583.0 | 1,568.0 | 845.0 | 720.0 |
| <i>% of Sales</i> | 20.5% | 15.1% | 14.3% | 15.9% | 15.8% | 19.3% |
| Research & Development | 665.0 | 564.0 | 614.0 | 604.0 | 303.0 | 290.0 |
| <i>% of Sales</i> | 8.3% | 6.1% | 5.6% | 6.1% | 5.7% | 7.8% |
| Operating Inc. (loss) | 431.0 | 395.0 | 661.0 | (1,204.0) | (1,094.0) | (310.0) |

Note: All figures exclude restructuring costs. Operating Income for the six months ending 3/27/97 excludes \$375m of in-process research and development costs relating to the NeXT acquisition and \$155m of restructuring costs.

- Balance sheet info: For the period ending March 27, 1997, Apple recorded net cash of \$374m which included \$1,085m of debt and \$1,459m of cash and equivalents. Of the \$1,085 of debt outstanding approximately \$300 is senior notes (6.5% coupon, B rating, 10 year maturity in 2004) and \$670 is subordinated notes (6% coupon, CCC+ rating, 5 year maturity in 2001, callable in 1999). Total shareholder's equity was \$1,242 and net property, plant and equipment of \$556.
- Stock price performance



- Recent analyst commentary: Despite skepticism from analysts regarding Apple's goal of achieving profitability in the fourth quarter of 1997 through a restructuring process, the Company continues to focus on its strengths. These include a continued commitment to their solid positions in education and Internet publishing. Today Apple personal computers represent more than 55% of the installed base of computers in schools, grades kindergarten through 12. In addition, Apple computers run more educational software than any other personal computer. Mac has always been a stronghold in high-end desktop publishing and graphics market. Finally, Apple can also look to build on its unique customer loyalty, an asset not found in many of the other computer companies.

Next Steps

Subsequent to our initial meeting, we have spoken with Joe Stockwell about further developing our analysis of the leveraged disposition alternative. He indicated an interest in discussing it with us because we were the first to discuss it in depth ("of the people that we have talked to"). He thinks that this alternative may make a lot sense to examine and believes that Fred Anderson, Apple's CFO, would be interested in the exercise. I also discussed our unique ability to structure and finance the transaction. Doug Solomon has also echoed these sentiments in further conversations.

We have submitted a confidentiality agreement to Joe today in anticipation of Thursday's meeting. Joe has begun to assemble the imaging business financials and hopes to discuss them in depth during Thursday's meeting.